



MANAGEMENT DISCUSSION AND ANALYSIS

Mission and Organizational Structure

Federal Student Aid, a principal office of the U.S. Department of Education (the Department), ensures that all eligible individuals can benefit from federally funded or federally guaranteed financial assistance for education beyond high school. We consistently champion the promise of postsecondary education to all Americans—and its value to our society.

Federal Student Aid plays a central and essential role in supporting postsecondary education. We partner with postsecondary schools, financial institutions and other participants in the Title IV student financial assistance programs (Title IV programs) to deliver programs and services that help students finance their education beyond high school. Today, Federal Student Aid is responsible for a range of critical functions that include, among others:

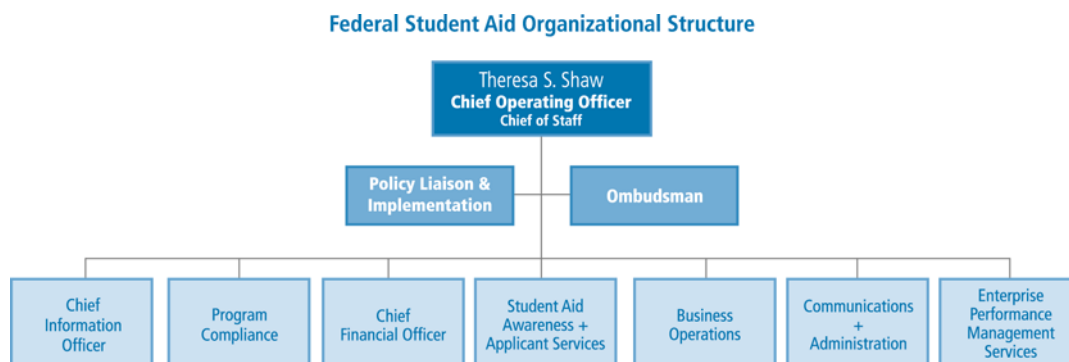
- Processing millions of student financial aid applications;
- Disbursing billions of dollars in aid funds to students through schools;
- Enforcing financial aid rules and regulations;
- Partnering with schools, financial institutions and guaranty agencies to prevent fraud, waste and abuse;
- Educating students and families on the process of obtaining aid;
- Servicing millions of student loan accounts;
- Securing repayment from borrowers who have defaulted on their loans; and
- Operating information technology systems and tools that manage billions in student aid dollars.

This is a complex, multifaceted mission that calls on a range of staff skills, and demands coordination by all levels of management. Designated a Performance-Based Organization (PBO) by Congress in 1998, Federal Student Aid emphasizes tangible results and efficient performance, as well as the continuous improvement of the processes and systems that support our mission.

Federal Student Aid Organizational Structure

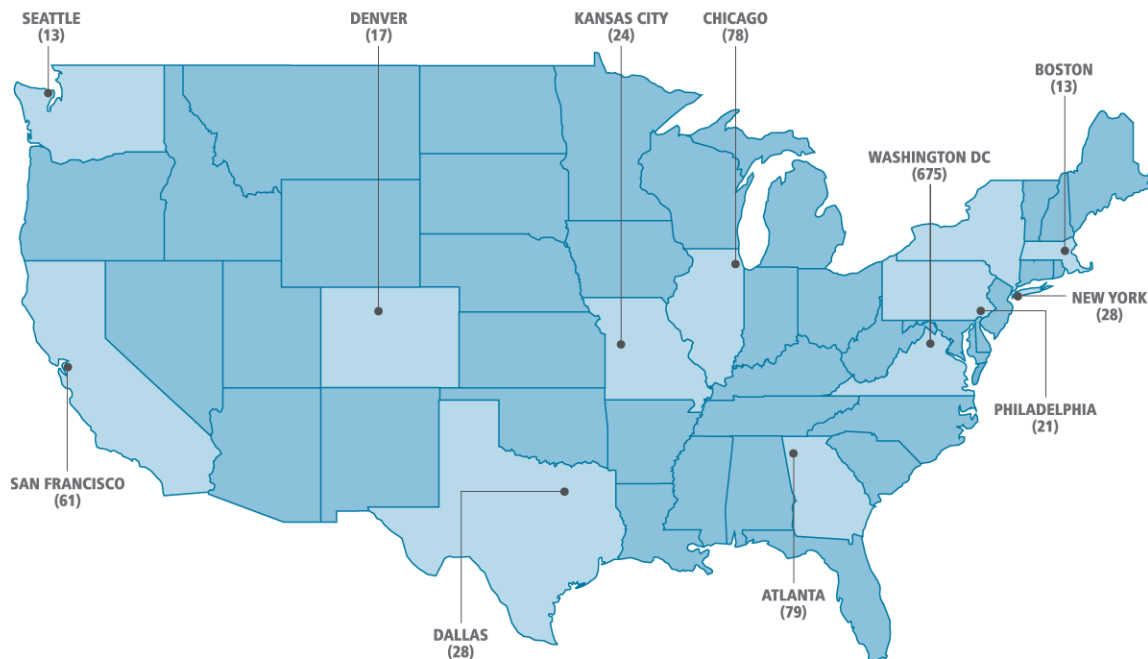
Federal Student Aid currently operates under a functional structure that aligns our organization closely with our strategic drivers, business objectives and mission goals. This structure reinforces a key business goal: efficient, effective and productive interaction with our many stakeholders.

This community of stakeholders includes students and parents, schools, lenders, guaranty agencies and taxpayers, as well as other federal entities and the Department itself. The graphic below illustrates the current functional structure of Federal Student Aid.



Chief Operating Officer Theresa S. Shaw, who was appointed to a five-year term by the Secretary of Education in 2002, leads Federal Student Aid. In fiscal year (FY) 2006, the organization operated on an annual administrative budget of \$658 million. Our staff of nearly 1,100 is augmented by contractors who provide outsourced business operations. This workforce is based out of Washington, D.C., with 10 regional offices located throughout the country.

Federal Student Aid Regional Map



As a federally designated PBO, Federal Student Aid operates under a congressional mandate to achieve concrete mission results as we improve efficiency in operations and manage and mitigate risks in Title IV portfolio performance. Federal Student Aid has focused on innovations for upgrading student aid delivery and servicing operations, vendor and contract management, budgeting and cost control and financial and operational management. Much of the resulting operational performance improvement stems from business process reengineering and large-scale technology integration.

Federal Student Aid is responsible for helping students manage the costs of education beyond high school. This duty includes administering the federal student financial assistance programs authorized under Title IV of the Higher Education Act (HEA) of 1965, as amended. The Title IV programs collectively represent the nation's largest source of financial aid for postsecondary students. In the paragraphs that follow, we briefly describe each of the major Title IV programs that deliver aid to students and their families.

The **Federal Pell Grant (Pell Grant) Program** helps ensure financial access to postsecondary education by providing grant aid to low- and middle-income undergraduate students. The most need-based of the Department's student aid programs, Pell Grant awards vary according to the financial circumstances of students and their families. For the 2005–2006 award year, the Department disbursed \$12.7 billion in Pell Grants averaging \$2,456 to more than 5.2 million students. The maximum Pell Grant award remained at \$4,050 for the 2005–2006 award year.

In February 2006, the president signed into law two new student grant programs—the **Academic Competitiveness Grant (ACG)** and **National Science and Mathematics Access to Retain Talent (SMART) Grant**, which were created by the Higher Education Reconciliation Act of 2005 (HERA). The ACG is for full-time undergraduates, who are U.S. citizens and are eligible for a Pell Grant. The student must have completed a rigorous high school program, as determined by the state or local education agency and as recognized by the Secretary of Education. First-year students may receive an ACG award up to \$750, whereas second-year students may receive up to \$1,300 if they have maintained a cumulative grade point average (GPA) of at least 3.0. The ACG award is available in the 2006–2007 school year for first-year students who graduated high school after January 1, 2006, and second-year students who graduated high school after January 1, 2005. The ACG award is in addition to the student’s Pell Grant award.

The National SMART Grant Program provides up to \$4,000 to third- and fourth-year undergraduates studying full-time and majoring in physical, life or computer sciences, mathematics, technology, engineering or in a foreign language critical to national security. The student must be a U.S. citizen and meet eligibility requirements for a Pell Grant. The student must maintain a cumulative GPA of at least a 3.0 for coursework required for the major. The grant award is in addition to the student’s Pell Grant award.

A student cannot receive more than one ACG or National SMART Grant award in each academic year for which they are eligible.

The **Federal Supplemental Educational Opportunity Grant (FSEOG)**, the **Federal Work-Study (FWS)** and the **Federal Perkins Loan (Perkins) Programs** are three campus-based programs through which the Department provides funds directly to eligible institutions, enabling them to offer grants, employment and low-interest loans to students based on need. For the 2005–2006 award year, approximately \$3.3 billion was disbursed through approximately 2.6 million campus-based awards.

There are two **state grant** programs. The **Leveraging Educational Assistance Partnership (LEAP) Program**, authorized by Section 415A of the HEA of 1965 (as amended), makes federal funds available to assist states in providing student financial assistance programs for individuals with substantial financial need. The **Special Leveraging Educational Assistance Partnership (SLEAP) Program** was added to the LEAP Program in the 1998 Amendments to the HEA (Section 415E). SLEAP makes federal funds available to states to cover a third of the cost of supplementing their respective LEAP programs, supplementing their LEAP Community Service Work-Study programs, and/or providing Merit and Academic Achievement or Critical Careers Scholarships, to students with substantial financial need.

Two major student loan programs account for nearly all of the remainder of the Department’s financial assistance for postsecondary education. Loans made to students can either be subsidized or unsubsidized. With subsidized loans, the government pays the interest while the student is in school and during qualified periods of grace and deferment. This is not the case with unsubsidized loans, where the student borrower is responsible for paying the interest on the loan. Loans to parents of students are also available.

In FY 2006, Federal Student Aid delivered or supported the delivery of approximately \$77 billion in federal aid to over 10 million postsecondary students and their families. These students attend more than 6,100 institutions of postsecondary education accredited by dozens of agencies. Many of these students receive loans from approximately 3,200 lenders with 35 agencies guaranteeing those loans.

In fulfilling our program responsibilities, Federal Student Aid directly manages or oversees more than \$448 billion in outstanding loans—representing almost 80 million student loans to over 27 million borrowers.

The **Direct Loan Program** lends funds directly to students and parents through participating schools. This program is funded by borrowings from the U.S. Treasury, as well as an appropriation for subsidy costs. In FY 2006, the Department made \$12.4 billion in net loans¹ to 1.8 million recipients.

Under the **Federal Family Education Loan (FFEL)** Program, students and parents can obtain loans through private lenders. Loan guaranty agencies insure these funds, and they are, in turn, reinsured by the federal government. During FY 2006, Federal Student Aid supported the delivery of \$46.2 billion in net loans² to 6.2 million FFEL recipients. In the same year, Federal Student Aid made gross payments of \$8.9 billion to lenders for interest and special allowance subsidies, and \$4.6 billion to guaranty agencies for reinsurance claims and fees paid to guaranty agencies for loan processing, issuance and account maintenance.

¹ Excludes consolidation loans of \$20 billion.

² Excludes consolidation loans of \$81 billion.

Performance Goals, Objectives and Results

Since Federal Student Aid became a PBO in 1998, we have introduced many substantial and measurable improvements in how we plan and report our operational and portfolio performance in administering the federal student financial assistance programs.

Strategic Planning and Reporting

Several key strategic drivers form the scope and content of Federal Student Aid's long-term goals and objectives:

- HEA Legislation
- Federal Financial Management Laws and Regulations
- Customer Needs
- PBO Legislation
- The Department's Strategic Plan
- The President's Management Agenda (PMA)
- The Department's Management Challenges

The foundation of our long-term strategic planning is Federal Student Aid's five core strategic objectives. Taken collectively, these objectives provide the framework for continuous improvement at Federal Student Aid, guiding us in managing our programs more effectively and providing clear strategic direction to all of Federal Student Aid's internal and external constituencies.

Our core strategic objectives are:

- To integrate Federal Student Aid systems and provide new technology solutions;
- To improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement;
- To reduce program administration costs;
- To improve human capital management; and
- To improve products and services to provide better customer service.

Federal Student Aid's long-term planning is outlined in its ***Five-Year Plan***, a statement of strategic direction providing long-term guidance. Beginning with the FY 2006 – FY 2010 ***Five-Year Plan***, Federal Student Aid established and documented strategic performance standards to measure the organization's success in meeting the stated long-term objectives. Federal Student Aid will begin reporting our performance as measured by these established standards in this report.

Tactical Planning and Reporting

Federal Student Aid's ***Annual Performance Plan*** establishes specific tactical initiatives to achieve each of the organization's strategic objectives outlined in the ***Five-Year Plan***. Timelines, milestones and status are maintained in the ***Annual Performance Plan*** and evaluated on a monthly basis to ensure their alignment with current business needs, the allocation of resources, the availability and allocation of capital and operating funds, policy considerations, and statutory and regulatory requirements.

The ***Annual Report*** provides the mechanism for reporting the organization's annual tactical performance results, including the organization's audited financial statements and the organization's progress in meeting tactical goals established in the ***Annual Performance Plan***. These three documents—the ***Five-Year Plan***, the ***Annual***

Performance Plan and the **Annual Report**—form the foundation of Federal Student Aid’s strategic planning, tactical implementation and reporting processes.

Additionally, Federal Student Aid continues to improve the systems and procedures used to identify, budget, select, monitor and improve operations. Performance monitoring includes weekly and monthly project planning and reporting activities detailing the scope, schedule, cost, quality and overall status of key initiatives. Federal Student Aid’s budget management processes and our unit-cost model provide cost identification, control and management. Federal Student Aid also continually tracks and reports enterprise-wide operational, human capital and performance metrics through a series of dashboard reports.

Key Performance Goals and Results

This section provides a high-level overview of Federal Student Aid’s FY 2006 performance objectives and results. The information presented in the following section provides a summary of our achievements and our progress in meeting the organization’s stated performance standards. See the Annual Program Performance Report section of this report for additional information regarding our accomplishments and Federal Student Aid’s FY 2006 Annual Performance Plan for specific details regarding the organization’s progress in meeting each Performance Plan tactical goal.

During FY 2006, Federal Student Aid made significant accomplishments, as well as progress in meeting our performance standards as outlined in the FY 2006 – FY 2010 Five-Year Plan. Under each objective below, we have identified the corresponding Performance Standard as well as the organization’s progress in meeting the stated target. Unless otherwise noted, these performance standards and their respective ratings are based on criteria established by Federal Student Aid.

Objective 1: Integrate Federal Student Aid systems and provide new technology solutions.

Federal Student Aid will improve efficiency and productivity, reduce system maintenance and overhead costs and increase the operating ease for users of our systems. Federal Student Aid will continue to provide appropriate and integrated technology solutions that enable ongoing improvements for a more efficient and cost-effective delivery and administration of the federal student financial assistance programs. In addition, the organization will take advantage of new technologies to improve application processing, customer service, productivity and efficiency. In FY 2006, we successfully:

- Awarded a four-year contract for the development of the Integrated Partner Management System (IPM). The IPM project will integrate, modernize and reengineer Federal Student Aid monitoring and oversight functions and provide better customer service to trading partners using a single sign-on process to multiple Federal Student Aid systems.
- Awarded a ten-year contract to operate the Virtual Data Center (VDC). The VDC houses the basic computer systems that support and operate delivery of Title IV student aid.
- Integrated three new systems into the security architecture infrastructure.
- Completed the enterprise portal strategy for the consolidation of many of the existing Web sites.
- Ranked 4th of all government agencies in the Office of Management and Budget’s (OMB) Enterprise Architecture assessments.
- Attained a “green” score on the PMA scorecard for e-Gov initiatives and received the Department of Labor’s Partner Appreciation Award.

- Continued identifying requirements and completed a technical proof of concept for the ADvance solution, an initiative to modernize and integrate the organization's core front-office business functions through the reengineering, retirement and replacement of existing aid delivery systems.
- Continued design of the Common Services for Borrowers initiative, a solution that consolidated Federal Student Aid's back-office systems for Direct Loan Servicing, Consolidation and Collections into a single integrated solution.
- Completed the conceptual design and high-level functional specifications for the Information Framework solution, an initiative to improve Federal Student Aid's business operations and data management functions by centralizing data transformation services, serving as a centrally accessible record for shared data, and increasing the standardization, quality and traceability of the master data shared among Federal Student Aid systems.

Performance Standards and Results

The following performance standards were established to measure our success in achieving our key integration initiatives. Success is predicated on the timely completion of all scheduled project deliverables in the design, development and implementation phases of the four main systems integration initiatives as described below.

Objective 1: Integrate Federal Student Aid systems and provide new technology solutions.			
Integration Initiative	FY 2006 Target	FY 2006 Actual	Performance
Common Services for Borrowers ¹	Development	Design	Target Not Met
ADvance ²	Development	Design	Target Not Met
Integrated Partner Management	Design	Design	Target Met
Information Framework	Design	Design	Target Met

¹ The Common Services for Borrowers project did not meet its projected target due to delays in meeting established timelines.

² The ADvance project did not meet its projected target due to a change in the acquisition strategy.

Objective 2: Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement.

Federal Student Aid will ensure that student aid under the Title IV programs is delivered directly by Federal Student Aid and through school, lender and guarantor participants in a manner that reduces the vulnerability of these programs to fraud, waste, abuse and mismanagement. Federal Student Aid is continually working to improve program integrity and is committed to continued success in the management of the Title IV programs. In FY 2006, we successfully:

- Achieved a "green" progress score on the September 30, 2006 PMA scorecards for Financial Management and Eliminating Improper Payments and a "yellow" progress score for Credit Management as of September 30, 2006. Achieved status scores of "green" for Financial Management, "yellow" for Eliminating Improper Payments and "red" for Credit Management also as of September 30, 2006.
- Developed and will publish the first iteration of the Cumulative Lifetime Default Rate for the Title IV student loan portfolio.
- Achieved a continued low rate for the National Cohort Default Rate (NCDR) for FY 2004.
- Achieved FY Direct Loan and FFEL default recovery goals for FY 2006.

- Developed and implemented standardized processes across Federal Student Aid's regional offices for reviewing the schools that participate in the Title IV programs. This implementation included the training of many school program review staff.
- Developed and implemented a standard model for evaluating Voluntary Flexible Agreements (VFA) for cost neutrality.
- Achieved an unqualified audit opinion for FY 2006 for the fifth consecutive year.
- Developed and implemented a management tool to evaluate the financial condition, including reserve ratios and fund balances, of guaranty agencies.
- Developed a strategy to improve the monitoring of publicly traded schools.
- Successfully implemented OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A and sound financial management controls. In addition to complying with OMB requirements, Federal Student Aid established an internal control framework to be leveraged for continuous internal control improvement.
- Volunteered to complete a physical inventory of assets in response to an unanticipated issue with the Department's Information Technology asset management inventory.
- Successfully upgraded the financial management system (FMS) to Oracle Federal Financials application version 11i and database version 10g.

Performance Standards and Results

The following performance standards were established to gauge our success in improving program integrity, while reducing the vulnerability of the Title IV programs to fraud, waste and abuse. Our success relies on maintaining "green" status on the PMA, continuing to achieve low default rates and increasing the recovery rate.

Objective 2: Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement.				
Metric	FY 2006 Target	FY 2006 Actual		Performance
PMA score for financial management*	Green	Green		Target Met
PMA score for improper payments*	Yellow	Yellow		Target Met
Cumulative Lifetime Default Rate – Title IV Student Loan Portfolio	Develop Baseline	FY 1999	12.24%	Target Met
		FY 2000	11.82%	
		FY 2001	9.93%	
		FY 2002	7.82%	
		FY 2003	5.48%	
Cohort Default Rate	< 6%	5.1%		Target Met
Direct Loan Default Recovery Rate	19.0%	19.0%		Target Met
FFEL Default Recovery Rate	19.3%	19.4%		Target Met

*See www.results.gov for definitions, trend and PMA scorecard support for both financial management and improper payments.

Objective 3: Reduce program administration costs.

Federal Student Aid will reduce the cost of administering the Title IV programs through strong financial, operational and budget management; the reengineering of overly complex business processes; and simplification of the business application and computing environment to reduce system complexity, minimize integration challenges, align contracts and reduce vendor management. Our aim is to improve the exchange of data with program participants and across the Federal Student Aid enterprise. In recent years, Federal Student Aid has maintained a relatively flat operating budget, while supporting continued increases in program volume and workload. Federal Student Aid's ability to manage and control operating expenses is based on a philosophy of good fiscal management and continuous process improvement practices that increase productivity and operational efficiencies as well as innovation in our products, services and supporting technologies. In FY 2006, we successfully:

- Completed the development of the unit cost baseline through our Activity-Based Costing (ABC) Model.
- Continued to manage and control operating expenses through efficiencies, productivity gains and capital savings.
- Awarded a ten-year contract to operate the VDC.
- Awarded a four-year contract for the development of the IPM.
- Developed and adopted a coordinated technical and business management approach to plan, execute and manage acquisitions, while ensuring the highest value of service is received for the lowest possible cost while allowing program management flexibility across all business functions.
- Increased business-analysis capabilities and better procurement planning supported by thorough market research resulted in several highly leveraged contract competitions that were negotiated in Federal Student Aid's favor.
- Significantly increased small-business participation through better internal controls, communications and management emphasis and support.

Performance Standards and Results

Performance standards were established to measure our ability to control costs in an environment of increasing workloads. Success relies on achieving economies of scale in our application, delivery, servicing and collection activities.

Objective 3: Reduce program administration costs.			
Metric	FY 2006 Target	FY 2006 Actual	Performance
Reduce electronic FAFSA direct unit costs	Develop Baseline	\$5.04	Target Met
Reduce origination and disbursement direct unit costs	Develop Baseline	\$4.42	Target Met
Reduce Direct Loan Servicing direct unit costs	Develop Baseline	\$20.95	Target Met
Reduce Collections direct unit costs	Develop Baseline	\$0.14	Target Met

Objective 4: Improve human capital management.

Human capital management is a critical component of Federal Student Aid's current business operations and future initiatives. Federal Student Aid continues to grow as an organization that empowers individuals to perform at a high level of effectiveness and efficiency. Federal Student Aid is utilizing innovative hiring and employee development techniques aimed at attracting and retaining highly qualified individuals to create a more productive, results-oriented workforce. Additionally, the organization is committed to workforce development and training to ensure a skilled and highly qualified professional workforce. In FY 2006, we successfully:

- Developed a baseline of data to measure the use of training resources to develop a highly skilled workforce to ensure competency in mission-critical skills/knowledge. This work first involved reaching agreement on mission-critical skills and developing an approach to collecting the data.
- Sought and was granted (on January 9, 2006) additional delegations of human resources authority from the Secretary, with respect to operations, as we interact and collaborate with the rest of the Department, including the Office of Management (OM).
- Continued our progress in institutionalizing sound performance management using the Department's Five-Tier Performance Management System and holding managers accountable for accurately and fairly rating individual performance. The ongoing goal is to clearly differentiate between the five different levels of performance and the delivery of real results.
- Established a new Federal Student Aid Executive Management coordinating structure and realigned large segments of the organization to accomplish key objectives.

Performance Standards and Results

The performance standard for improving human capital management measures our ability to maintain a skilled and knowledgeable workforce. Specifically, the performance measure will identify our mission-critical competencies, identify where current or potential weaknesses exist and identify training plans for individuals to further develop competency/skills/knowledge.

Objective 4: Improve human capital management.			
Metric	FY 2006 Target	FY 2006 Actual	Performance
Use training resources to develop a highly skilled workforce to ensure competency in mission-critical skills/knowledge	Develop Baseline	Leadership Train 100% New Supervisors Train 52% Current Supervisors	Target Met
		Acquisitions Train 100% Contracting Officials	
		Project Management Train 100% Key IT Project Managers	
		Federal Student Aid Business Knowledge Train 90% New Employees Train 10% School Compliance Officials Train 40% General Workforce	

Objective 5: Improve products and services to provide better customer service.

Federal Student Aid will make a continuous effort to improve products and services to students and their families and program participants such as schools, lenders and guaranty agencies. Being aware of the concerns of customers is a critical component of our efforts to improve federal student aid products and services. Federal Student Aid intends to reduce the complexity of our products and services, ensure that compliance is maintained, provide customers with 24/7 access and promote increased self-service opportunities for customers. In addition, Federal Student Aid will continue to develop strategies to provide integrated solutions for customers. In FY 2006, accomplishments included:

- The FY 2006 American Customer Satisfaction Index (ACSI) ratings for Federal Student Aid's highest volume products and services – including Direct Loan Servicing, *FAFSA on the Web*, the Common Origination and Disbursement system (COD) and the Lender Application and Reporting System (LaRS) – score in the “Excellent” and “Good” range. The COD system received an improved ACSI score.
- Continuation of the multi-year enterprise communications strategy that was launched in FY 2005 to better articulate the benefits of postsecondary education, raise awareness of federal student aid programs and improve consistency across all communications to its many stakeholders, including currently underserved communities. In FY 2006, Federal Student Aid began full-scale implementation of this strategy, launching a new Federal Student Aid brand and incorporating it across multiple points of presence.

Performance Standards and Results

The following performance standards were established to measure our success in meeting and exceeding customer service goals. Specifically, success is realized with continuous improvement in our customer satisfaction scores for our four main systems.

Objective 5: Improve products and services to provide better customer service.				
Metric (In percentages)	FY 2006 ACSI Benchmark¹	Revised FY 2006 Target²	FY 2006 Actual	Performance³
Student aid application	75	83	80	Target Not Met
School origination and disbursement	68	76	77	Target Met
Lender payment processing	68	74	71	Target Not Met
Direct Loan borrower servicing	75	77	79	Target Met

More detailed accomplishments are provided in the Annual Program Performance Report section of this document.

¹ ACSI Benchmarks are the average score for private companies in a comparable industry sector.

² Federal Student Aid performance targets, established last year and included in the FY 2006 – 2010 Five-Year Plan to measure customer service, were delineated in percentile rank. This was done to provide a common measure of customer satisfaction, regardless of the method or company used to conduct the customer satisfaction surveys. Unfortunately, because it was discovered that so few companies are included in the ACSI sector benchmark averages, the percentile rank does not accurately reflect true performance. For example, a single-point change in the ACSI score of *FAFSA on the Web* resulted in a 21 percent change in percentile ranking.

To establish a better and more representative performance standard to measure customer satisfaction with Federal Student Aid products and services, we have updated our performance measures and targets based on actual ACSI sector averages. If, in the future, we utilize a different gauge of customer satisfaction, we will update our performance standards accordingly.

³ In FY 2006, Federal Student Aid exceeded its revised customer satisfaction targets for school origination and disbursement and Direct Loan borrower servicing. However, Federal Student Aid did not meet its revised customer satisfaction targets for online student aid application processing or lender payment processing.

Data Quality of Performance Information

Effective decision making requires complete, accurate and reliable data. Funding decisions are made and management actions are taken based on performance information. Reliable information is a prerequisite for effective management. In addition to performance data received from our operating partners, we deal with financial data. Our data-quality processes for financial data are reflected in our financial statements and accompanying notes. Federal Student Aid develops and uses such data for various purposes. One of the most visible areas in which this occurs is the annual budget-development process. The central focus of our budget process is to align goals, objectives, performance measures and program funding levels to develop a performance budget. One of the five government-wide elements of the PMA is the integration of budget and performance, which focuses on making budget decisions based on results.

Federal Student Aid, facing opportunities provided by the integrated performance-based budget process and activity-based management, recognizes the need to improve the accuracy, reliability and completeness of our data. Although immediate connections between specific performance and funding levels are sometimes challenging to make, Federal Student Aid is improving systems to yield reliable performance data to make informed budget and policy decisions. These systems will enhance our budget process and increase the accuracy and reliability of the information we receive from our operating partners.

Analysis of Federal Student Aid's Financial Statements and Stewardship Information

Federal Student Aid is committed to providing sound management, financial systems and controls to ensure that students receive aid and repay loans according to applicable laws and regulations. Federal Student Aid's financial statements are prepared in conformance with accounting principles generally accepted in the United States. Federal Student Aid financial statements are subject to an annual independent audit to ensure that they are reliable and fairly present our financial position.

In FY 2006, Federal Student Aid achieved a fifth consecutive unqualified audit opinion on our financial statements. The Independent Auditor's Report cited no material weaknesses in internal controls. This sustained achievement was critical to Federal Student Aid's removal in FY 2005 from the Government Accountability Office's (GAO) High-Risk List and was the result of substantial improvements to internal controls, continued improvement in our accounting and financial processes and Federal Student Aid's strategic planning and financial reporting.

For FYs 2006 and 2005, the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position and Statement of Financing were prepared on a consolidated basis, and our Statement of Budgetary Resources was prepared on a combined basis as required by OMB Circular A-136, *Financial Reporting Requirements*. The Report of Independent Auditors (opinion) on these statements and accompanying Reports on Internal Control and Compliance with Laws and Regulations are included in this report.

For the FFEL and Direct Loan programs, appropriations are available to cover the subsidy cost of each program, as well as administrative expenses. Subsidy expenses are the net present value of future cash flows. Appropriation authority is available as needed on a permanent basis to finance operations resulting from loans guaranteed in the years before FY 1992. The Pell Grant program receives appropriations that cover actual grant disbursements.

A comparison between significant line items reported in Federal Student Aid's FYs 2006 and 2005 financial statements is presented in the following table. The percentage change for Net Cost of Operations is primarily the result of an increase in FFEL costs as explained in the Statement of Net Cost section.

Summarized Financial Data			
(Dollars in Millions)			
	Percentage Change	FY 2006	FY 2005
Total Assets	19%	\$174,571	\$146,505
Total Liabilities	17%	\$166,084	\$142,455
Net Position	110%	\$8,487	\$4,050
Net Cost of Operations	64%	\$51,031	\$31,162

The Balance Sheet

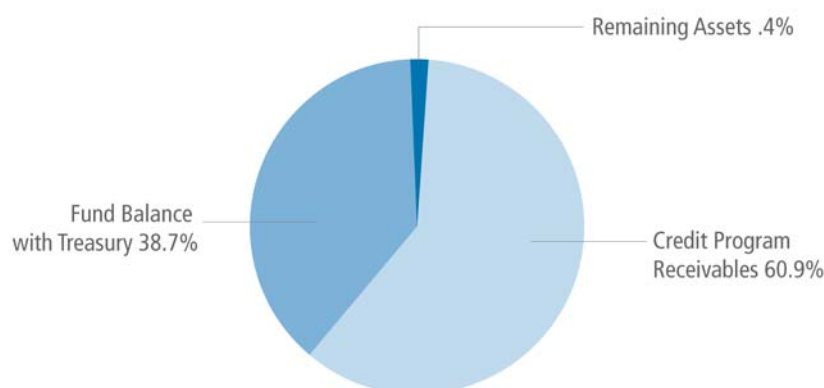
Composition of Federal Student Aid Assets

The Consolidated Balance Sheet shows Federal Student Aid had total assets of nearly \$175 billion, as of September 30, 2006. This represents an increase of approximately \$28 billion over the previous year's total assets of \$147 billion, as of September 30, 2005. The difference is primarily the result of a \$29.7 billion increase in Fund Balance with Treasury. The increase in Fund Balance with Treasury results from increases in the balances of about \$20.6 billion for FFEL, \$3.9 billion in the Direct Loan Program and \$5.2 billion for grants. Fund Balance with Treasury was increased primarily as the result of higher subsidy appropriations in the FFEL

Program, reflecting increases in upward subsidy re-estimates and modifications due to increases in loan consolidation volume.

Fund Balance with Treasury represents Federal Student Aid's funds available to make authorized expenditures and finance loan programs. The Treasury processes Federal Student Aid's cash receipts, such as warrants that provide cash for operations and loan payment collections received from students. The Treasury also processes operating expenditures and other disbursements on behalf of Federal Student Aid.

Assets as of September 30, 2006

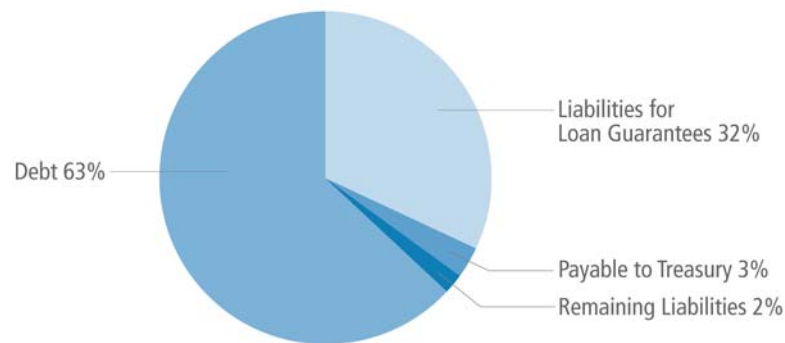


Credit Program Receivables decreased \$1.2 billion in FY 2006. Credit Program Receivables are comprised primarily of principal and interest amounts owed by students for Direct Loans and defaulted guaranteed loans under the FFEL Program. As of September 30, 2006, there was \$106.4 billion in Credit Program Receivables, the majority of which were Direct Loan program receivables of \$92.6 billion and FFEL Program receivables of \$13.6 billion. The credit program receivables for FFEL increased from September FY 2005 through September FY 2006 by \$1.9 billion. The credit program receivables for Direct Loans decreased by \$3.1 billion, primarily due to an increase in the allowance for subsidy. The allowance increased due to accruals for subsidy re-estimates to reflect higher consolidation loan volume and changes to the assumptions for collection rates on consolidation loans.

The remaining assets include Accounts Receivable, Cash and Other Monetary Assets, General Property, Plant, and Equipment and Other Assets.

Composition of Federal Student Aid Liabilities

Federal Student Aid had total liabilities, as of September 30, 2006, of \$166.1 billion. Of this amount, \$105.4 billion represents the balance due Treasury for previous borrowings used to fund disbursements of Direct Loans to students.

Composition of Liabilities as of September 30, 2006

Debt and Liabilities for Loan Guarantees increased during the period September 30, 2005 through September 30, 2006. Debt for the Direct Loan program expanded due to increases in new borrowings to support the disbursement of new loans over collections from borrowers. Total liabilities increased \$23.6 billion primarily due to increases in the Liabilities for Loan Guarantees in FFEL of \$21.8 billion and Debt for the Direct Loan program of \$1.1 billion. Liabilities for Loan Guarantees for FFEL increased due to upward re-estimates and subsidy transfers from increased loan consolidation activity. The Liabilities for Loan Guarantees under FFEL, which showed increased activity in FY 2006, are the estimated costs on a present-value basis of the net long-term cash outflows, resulting from loan defaults and lender payments that are offset by fees. Loan guarantees encourage private lenders to provide student education loans. The Payable to Treasury balance is the amount owed for downward subsidy re-estimates and for amounts that will be returned to Treasury after all pre-1992 loan guarantees have been satisfied.

The remaining liabilities include Accounts Payable, Guaranty Agency Federal and Restricted Funds Due to Treasury, Other Intra-governmental Liabilities, Accrued Grant Liability and Other Liabilities.

Statement of Changes in Net Position

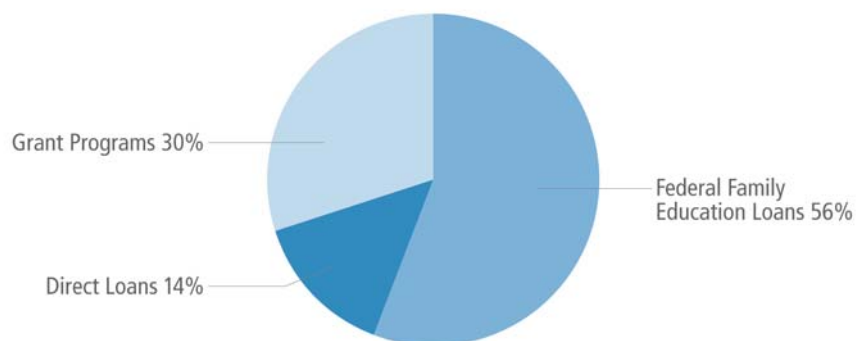
Federal Student Aid's Net Position as of September 30, 2006 is \$8.5 billion, which increased by \$4.4 billion, compared to \$4.1 billion at September 30, 2005. The increase was due primarily to higher unexpended appropriations for the Pell Grant Program. There was an increase in Pell Grant funding to eliminate the Pell Grant shortfall and an increase for the ACG program, a new program under HERA.

Statement of Net Cost

Federal Student Aid had total net costs of about \$51 billion during FY 2006. In the FFEL Program, the total net cost was about \$28.4 billion. In the Direct Loan program, total net costs were \$7 billion. The grant programs had a total net cost of \$15.6 billion. The gross costs are primarily composed of subsidy expenses and the funding of grants. Subsidy expenses are the estimated costs of funding the direct loans and loan guarantees. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows. Indirect costs are Departmental administrative costs including supplies, training costs, rent/lease agreements for Federal Student Aid occupied buildings, printer/fax/copier services, mail services and other costs allocated to each Federal Student Aid program as part of our effort to report full cost. There was an increase of approximately \$19.9 billion in net costs incurred in FY 2006 compared to FY 2005. This was primarily due to increases in FFEL gross costs of \$18.7 billion. Increases in upward re-estimates and subsidy transfers due to increased loan consolidation activity led to this increase. Also there were increases in

Direct Loan and Grants gross costs. The increase in gross costs for Direct Loans is due primarily to increased upward re-estimates and subsidy transfers due to increased loan consolidation activity. Gross costs were reduced by earned revenues for FFEL and Direct Loans.

Composition of Net Cost FY 2006



Statement of Budgetary Resources

The Statement of Budgetary Resources compares the budgetary resources provided with the status or execution of those resources and shows the amount of net outlays. This statement shows that Federal Student Aid had \$164.3 billion in combined budgetary resources, of which \$47.4 billion remained un-obligated and not available at year-end. Federal Student Aid had total net outlays for FY 2006 of \$25.1 billion. There was a decrease in total net outlays of \$757 million comparing September 2006 to September 2005. The decreases in Direct Loan and Grants net outlays were greater than an offsetting increase in FFEL net outlays, resulting in an overall decrease in total net outlays for Federal Student Aid. There was a decrease in the net outlays for Direct Loans due to increased offsetting collections.

Statement of Financing

The Statement of Financing demonstrates the relationship between an entity's proprietary and budgetary accounting information by linking the net cost of operations (proprietary) with net obligations (budgetary) through the identification of key differences between the two statements. The statement identifies \$29.7 billion of resources used to finance Federal Student Aid activities in FY 2006.

Significant budgetary resources used to finance items not part of net cost of operations include collections of principal and interest from borrowers; collections of subsidy for loan guarantees committed during the current period and adjustments to collections of subsidy for loan guarantees committed in prior periods; and disbursements for new loans and loan consolidations, default claims, and lender payments to commercial lenders.

Analysis of Federal Student Aid's Systems, Controls and Legal Compliance

Internal control is a major part of managing an organization. It comprises the plans, methods and procedures used to meet missions, goals and objectives and, in doing so, supports performance-based management. Internal control also serves as the first line of defense in safeguarding assets and preventing and detecting errors and fraud. In short, internal control, which is synonymous with management control, helps government program managers achieve desired results through effective stewardship of public resources.

Internal control should provide reasonable assurance that the objectives of the agency are being achieved in the following categories:

- Effectiveness and efficiency of operations, including the use of the entity's resources.
- Reliability of financial reporting, including reports on budget execution, financial statements, and other reports for internal and external use.
- Compliance with applicable laws and regulations.¹

Federal Student Aid management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA). Federal Student Aid conducted its assessment of the effectiveness of internal control over the effectiveness and efficiency of its operations and compliance with applicable laws and regulations in accordance with OMB Circular A-123, *Management's Responsibility for Internal Control*. Based on the results of this evaluation, Federal Student Aid reported to Department Management that its internal controls over the effectiveness and efficiency of its operations and compliance with applicable laws and regulations, as of September 30, 2006, were operating effectively, and no material weaknesses were found in the design or operation of the internal controls.

In addition, Federal Student Aid conducted its assessment of the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular A-123, *Management's Responsibility for Internal Control*. The scope of Federal Student Aid's assessment included the following processes that impact the Department of Education's financial statements:

- Direct Loan servicing
- Direct Loan originations and disbursements
- Direct Loan consolidations
- Grants disbursements (Pell and campus-based)
- Financial closing and reporting (month-end closing, journal voucher processing, reconciliations)
- Financial partner invoicing and oversight
- FFEL guaranty agency reserve fund
- Institutional eligibility (Direct Loans and grants)
- Debt management
- General computer controls related to various agency systems
- Katrina response

¹ GAO Standards for Internal Control in the Federal Government, GAO/AIMD-00-21.3.1, November 1999, p. 4-5

Also, in participating in the Department's successful implementation of OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A requirements, Federal Student Aid established a more robust internal control framework that will be used in continuing efforts to monitor and improve internal controls. Please refer to the Department's Performance and Accountability Report for information related to the Department's compliance with the Federal Financial Management Improvement Act.

Improper Payment Information Act (IPIA) Reporting

The IPIA of 2002 and OMB's implementing guidance requires agencies to annually review all programs and activities to identify those susceptible to significant improper payments. The guidance defines significant improper payments as those in any particular program that exceed both 2.5 percent of program payments and \$10 million annually. For each program identified as susceptible, agencies are required to report the annual amount of estimated improper payments, along with steps taken and actions planned to reduce them. Federal Student Aid achieved a "green" progress score on the September 30, 2006, PMA scorecard for Eliminating Improper Payments and status score of "yellow" for Eliminating Improper Payments for the same period.

OMB uses quarterly color-coded scorecards to monitor agencies' status and progress toward attaining the PMA program initiative goals. In conjunction with the requirements of the IPIA, a new key initiative, entitled *Eliminating Improper Payments*, summarizes the results of quarterly actions to ensure compliance with the IPIA.

Federal Student Aid measures and reports annual improper payment estimates for the Pell Grant and FFEL Programs. OMB automatically considers programs previously required to report under A-11, Section 57 as susceptible to significant improper payments, regardless of the established thresholds. Risk assessments conducted in FY 2006 indicated that other programs administered by Federal Student Aid are not at significant risk of improper payments.

For FY 2005, the preliminary rate for the FFEL error rate is 2.2%, based on an evaluation of the following information:

- Overpayments identified during Federal Student Aid's Financial Partners Service (FP) program reviews of guaranty agencies, lenders and loan servicers during FY 2005.
- Overpayments identified by independent public accountants (IPA) and third-party audit firms in Single Audit reports for guaranty agencies and lenders.
- Overpayments reported by the Department of Education's OIG in audits and reviews of guaranty agencies, lenders and loan servicers during FY 2005.
- Outstanding loan balance amounts at guaranty agencies, lenders and servicers selected for review by the OIG, IPAs and Federal Student Aid's FP.

For the Pell Grant program, the error rate from the FY 2005 Internal Revenue Service study is 3.48%.

During the fiscal year, the Inspector General issued an audit report that questioned payments made to an entity that participates in the FFEL Program. The findings cited in this report are under consideration by the Department. Until the matter is resolved, the potential impact, if any, on the Department's financial position is not possible to estimate.

Possible Future Effects of Existing Events and Conditions

Federal Student Aid's ability to fully implement the initiatives described in this report are impacted by external factors, including budget and policy considerations and unanticipated events. Federal Student Aid works closely with the Department and OMB to develop our administrative budget and ensure appropriate resources are allocated to support our strategic objectives.

Legislative and/or regulatory action may result in policy, resources or program changes requiring Federal Student Aid to revisit our current strategic plan. Specifically, the reauthorization of the HEA is scheduled to occur during this session of Congress. Once completed, Federal Student Aid will revise both our *Annual Performance Plan* and the *Five-Year Plan* to meet the new legislative and/or regulatory requirements.

Other external factors could also affect our ability to achieve the organization's objectives. For example, in August and September 2005, hurricanes Katrina and Rita caused extensive damage to the Gulf Coast region of the United States. As a result, Federal Student Aid mounted a large-scale response effort to assist our customers impacted by the unprecedented destruction of hurricanes Katrina and Rita. We are unable to anticipate the full cost or impact to Federal Student Aid's strategic objectives as a result of our long-term commitment to other similar unforeseen events.

Limitations of Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b).

While the statements have been prepared from the books and records of the entity in accordance with generally accepted accounting principles (GAAP) for federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.